# Today's Top Questions: Investments and Taxes

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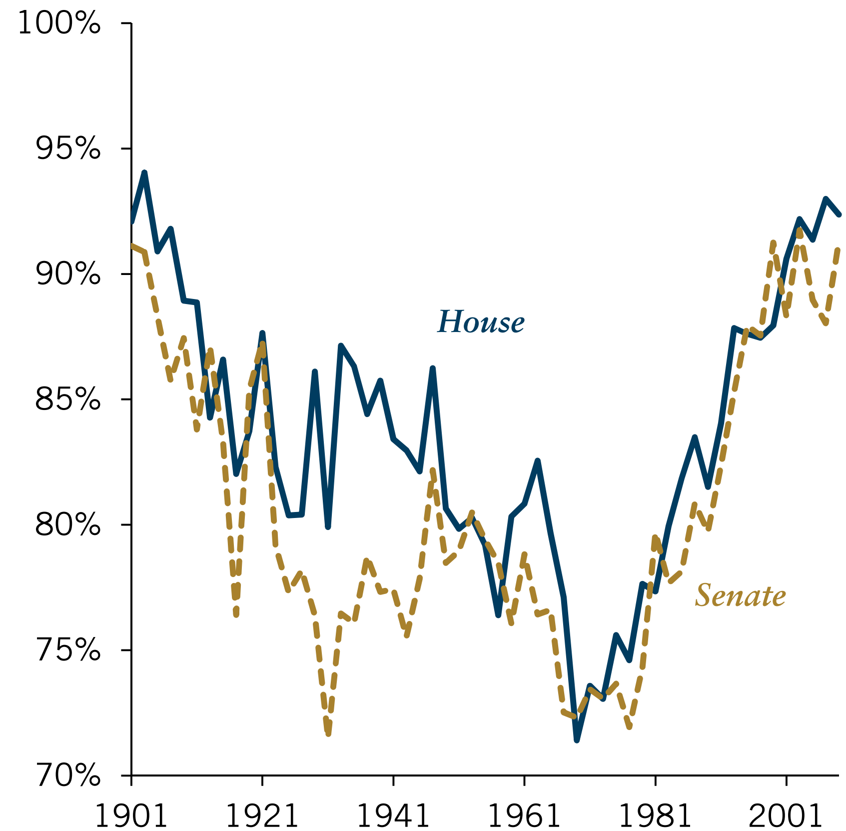
# Key Investment Questions into 2013

1. How will the U.S. election impact the U.S. economy and markets?
2. Will the euro survive?
3. Why is China not stimulating more to boost growth?
4. How should investors think about a potential Israel-Iran conflict?
5. When will we see a shift out of bonds into equities?
6. Are Alternatives losing their edge?
7. What's our bottom line?

# U.S. Election Outcome Will Shape "Fiscal Cliff" Risk

| Elements of the Fiscal Cliff[1] | Fiscal Year 2013 effect on deficit (billions) | % of Projected 2013 GDP |
|---|---|---|
| Expiration of Bush tax cuts, AMT patch, estate tax | $225 | 1.4% |
| Expiration of the 2% payroll tax cut for workers | $85 | 0.5% |
| Expiration of tax extenders, 50% bonus depreciation | $65 | 0.4% |
| Enactment of 3.8%, Medicare tax on unearned income | $18 | 0.1% |
| Enactment of Budget Control Act sequester | $54 | 0.3% |
| Expiration of extended unemployment insurance | $34 | 0.2% |
| Expiration of Medicare "Doc Fix" payments | $10 | 0.1% |
| **Total** | **$491** | **3.0%** |

**U.S. Congressional Polarization at Extreme[2]**




[1]August 2012 Budget and Economic Outlook includes economic feedback effects from the weakening of the economy if the cliff is hit. The CBO estimates this "multiplier effect" would be $105 billion. If included, the fiscal year 2013 impact on the deficit is closer to $595 billion, or 3.7% of GDP.

[2]Polarization data is through December 31, 2009 as of January 11, 2011 (updated every two years).

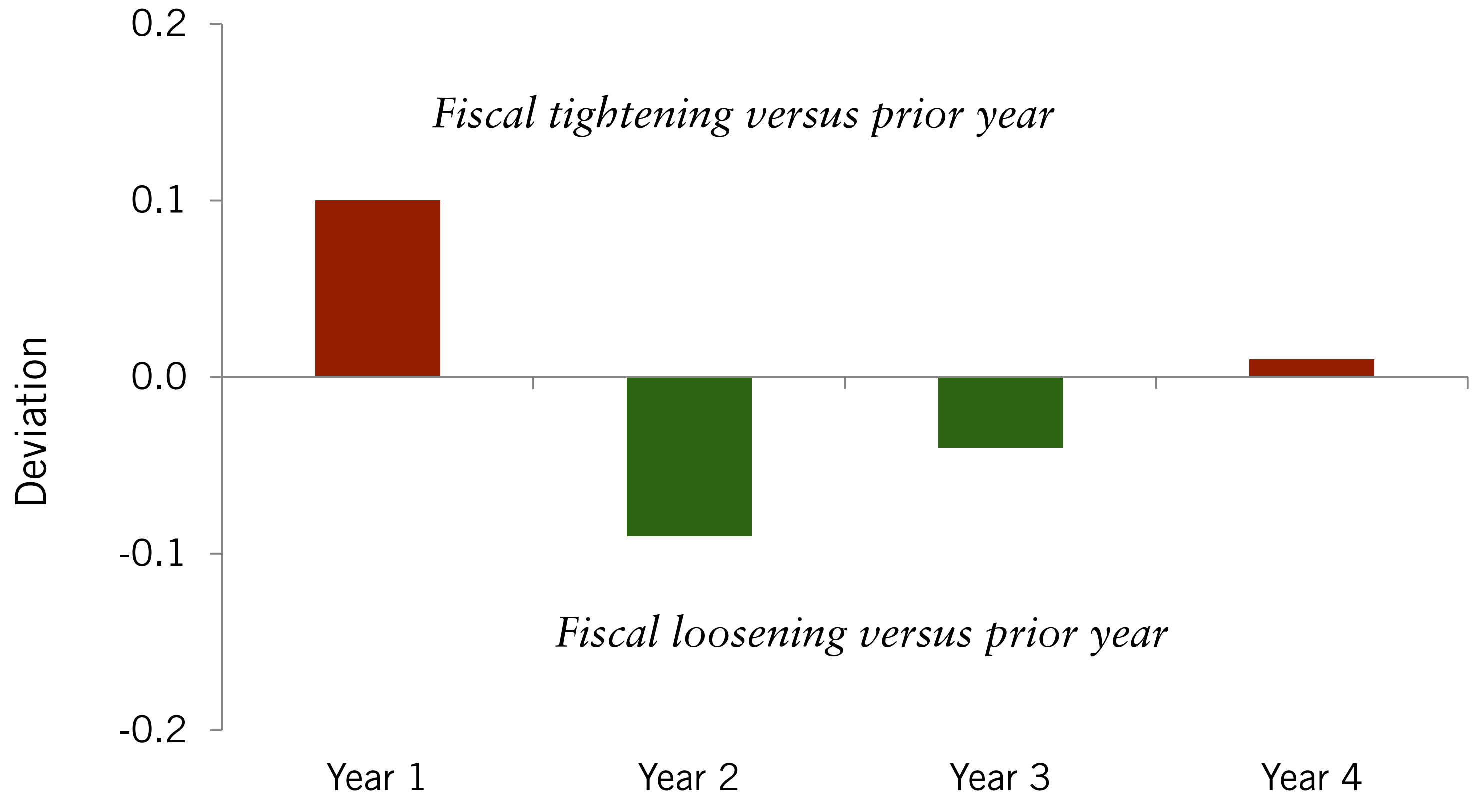
Source: Congressional Budget Office, Poole and Rosenthal Political Party Unity

# Fiscal Cliff Scenarios

| Scenario | Our thoughts | Portfolio implications |
|---|---|---|
| **Lame duck "grand bargain"** | • *Highly* unlikely given time constraints and logistical hurdles | • Best-case scenario for cyclical assets; "risk on" |
| **Kick the can – postpone the cliff by 3-6 months** | • Most realistic scenario, in our view<br>• Better than jumping off cliff but may prolong market uncertainty<br>• Communication key to short-term market reaction | • Volatile markets and fickle sentiment likely to linger<br>• Equity upside limited<br>• Remain focused on "defensive growth" assets |
| **Jump off the cliff** | • Unlikely but possible, especially if new Congress/Administration want to wait until in office to act<br>• Market reaction would depend on details – how clear would it be that cliff would be dealt with quickly and retroactively | • Potential allocation shifts depending on details |

# Fiscal Drag in 2013 Would Follow Historical Pattern of U.S. Electoral Cycle

**Deviation from long-term average; change in adjusted fiscal balance as a % of GDP, percentage points**




As of January 31, 2012. Data shown is from 1960-2012.
Source: Congressional Budget Office

# The 2013 U.S. Economic Tug of War

Dragging GDP

- Fiscal tightening
- Slow wage growth
- Global stresses: China, Europe, Middle East

- Policy clarity – taxes, health care, regulation
- Political partisanship

?

- Monetary policy/low yields
- Housing market
- Weak dollar – exports
- Relatively strong corporate balance sheets

Lifting GDP

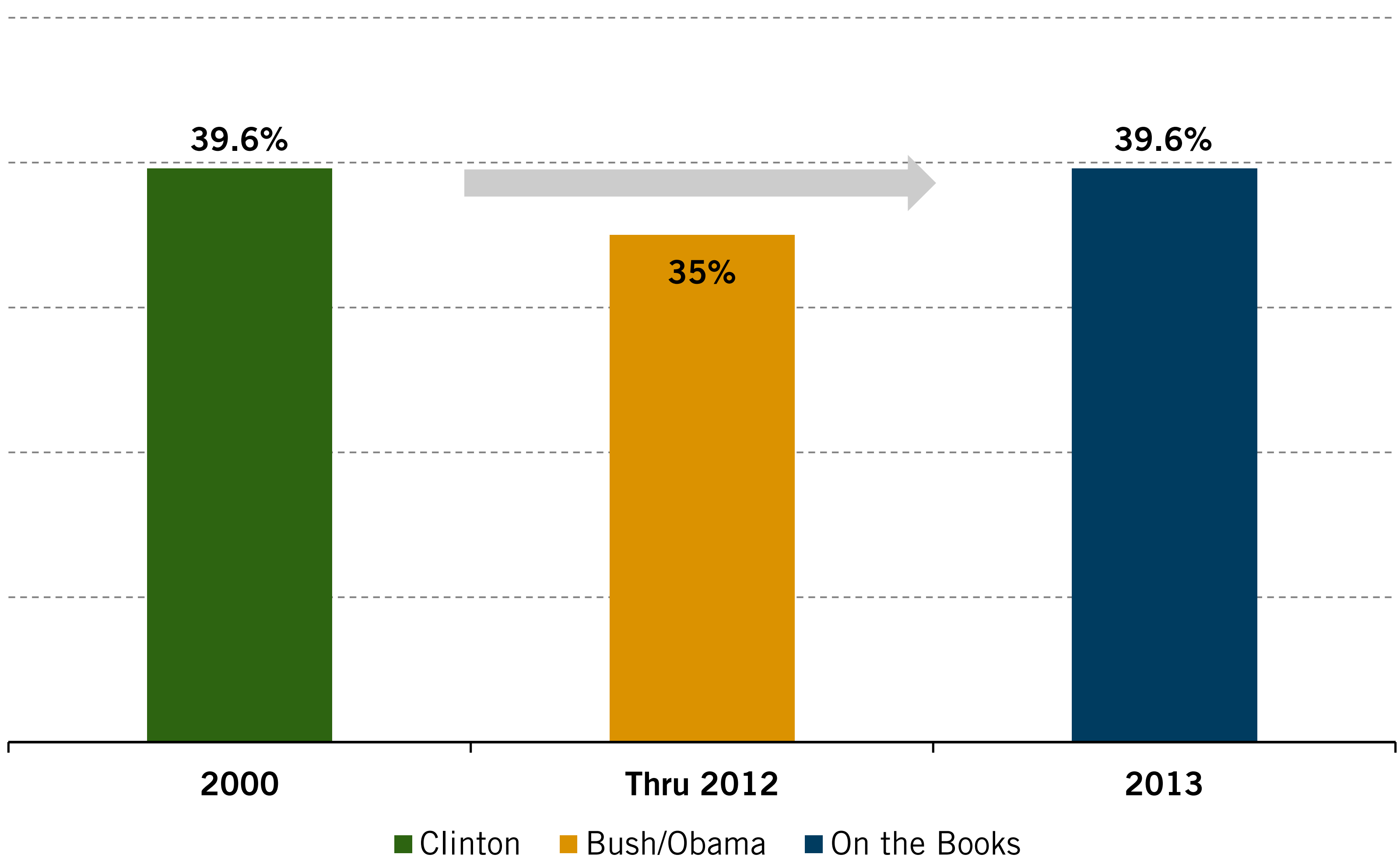
# Time Out for Taxes

- Without legislative changes this year, what is the outlook for taxes in 2013?

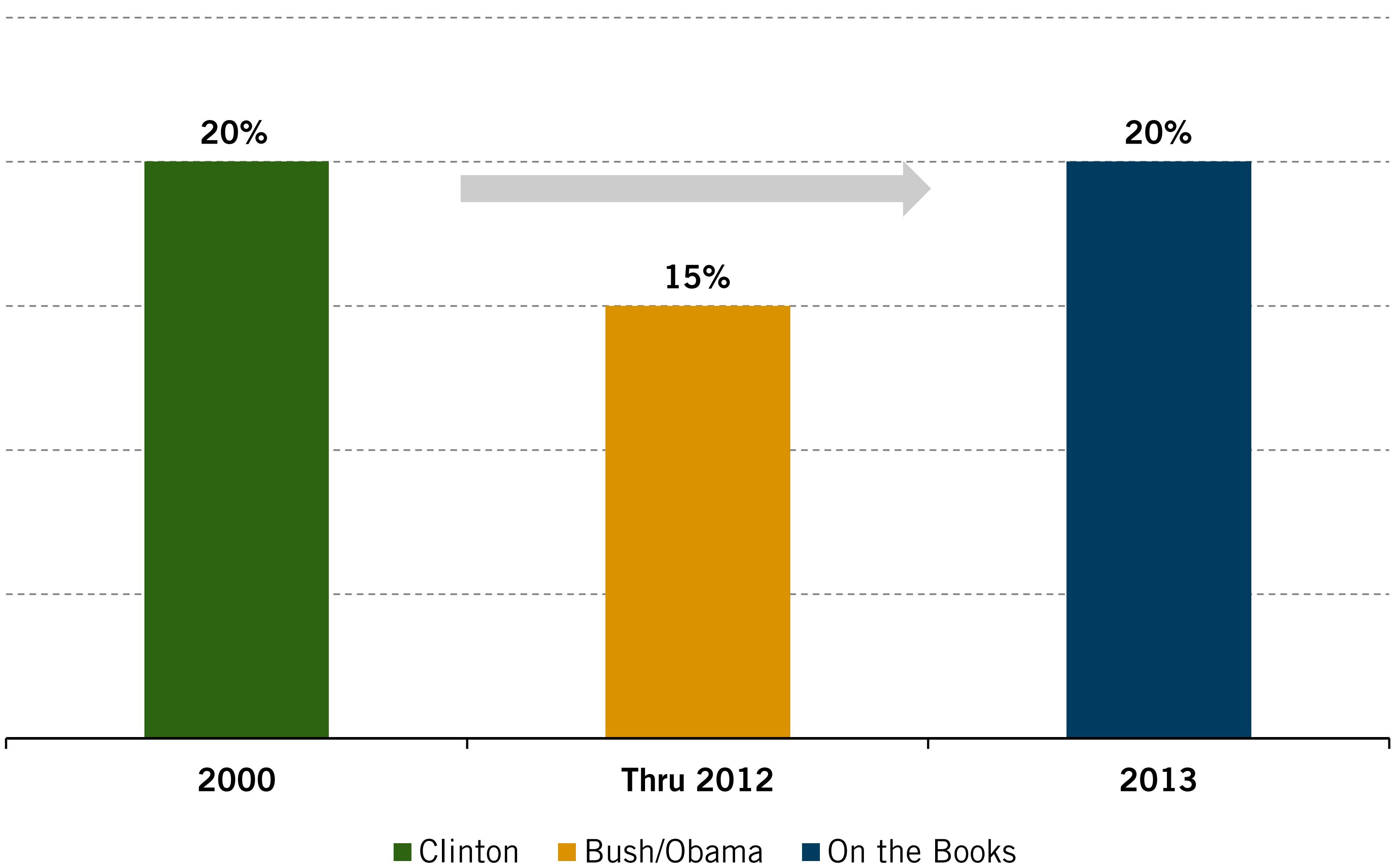
- What impact might the election have on taxes? How are Obama's and Romney's tax policies different?

- What can wealthy taxpayers do now to prepare for a potentially harsher tax environment next year?

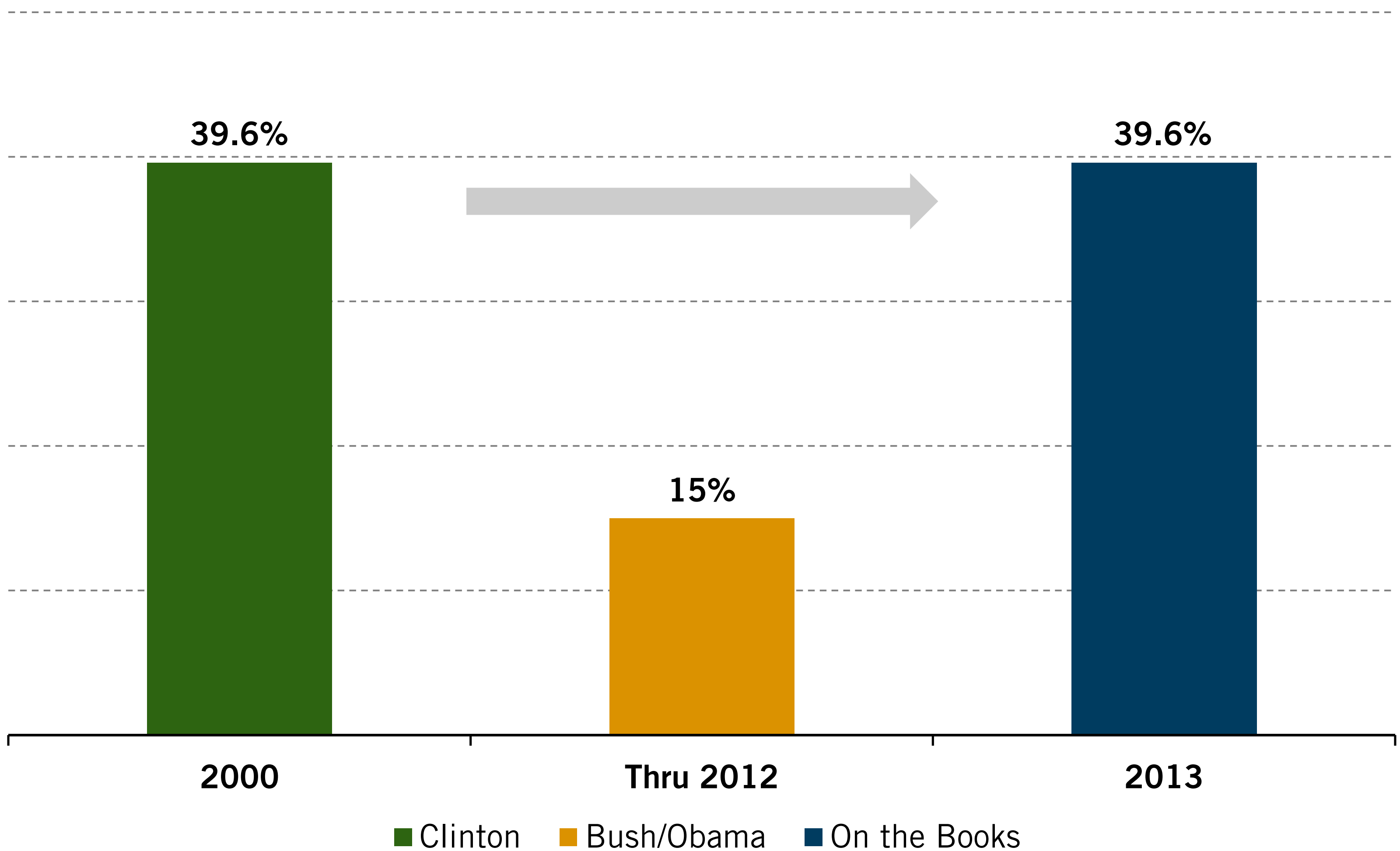
# Ordinary Income: Wages, Interest, Rent, Business Income



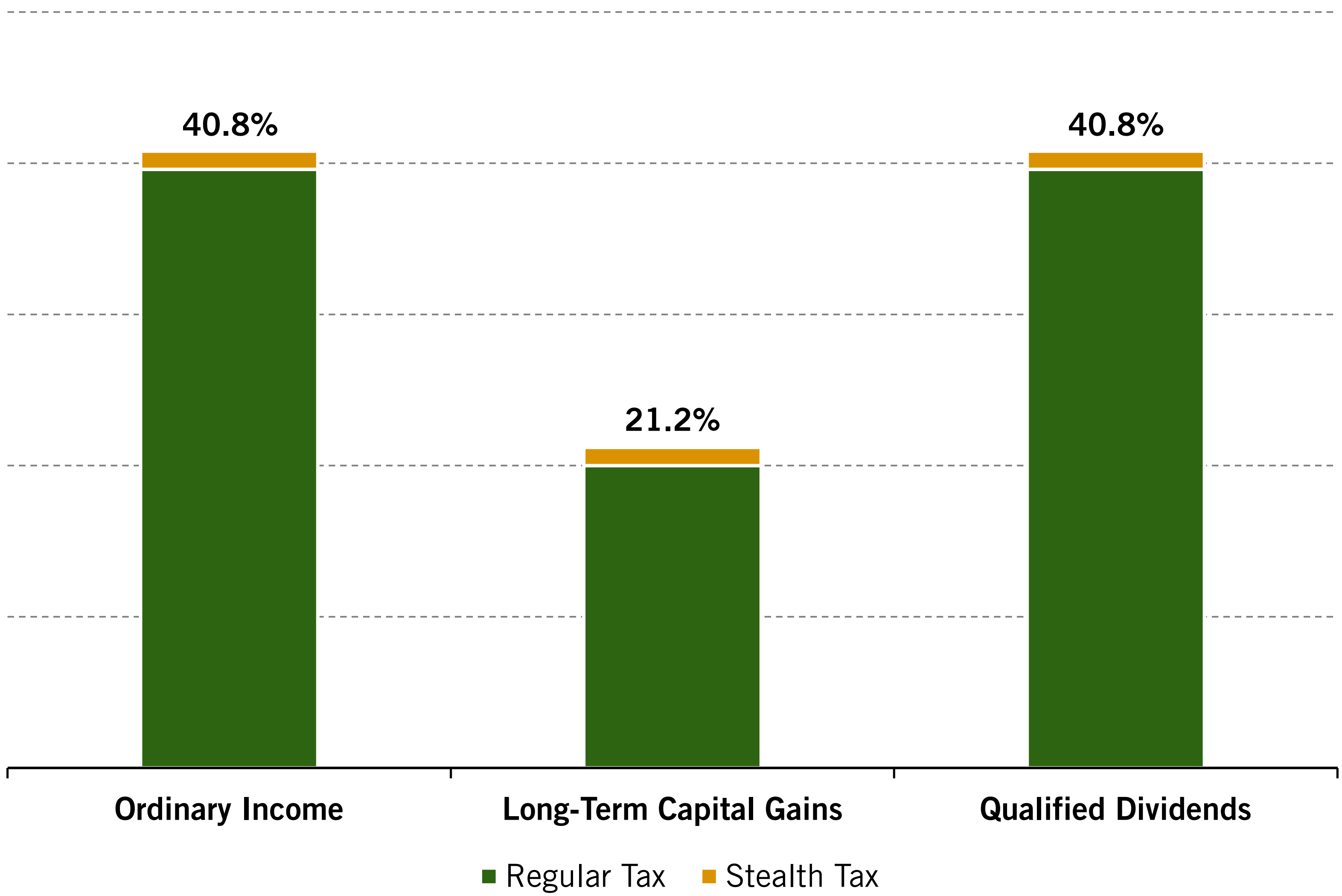
# Long-Term Capital Gains



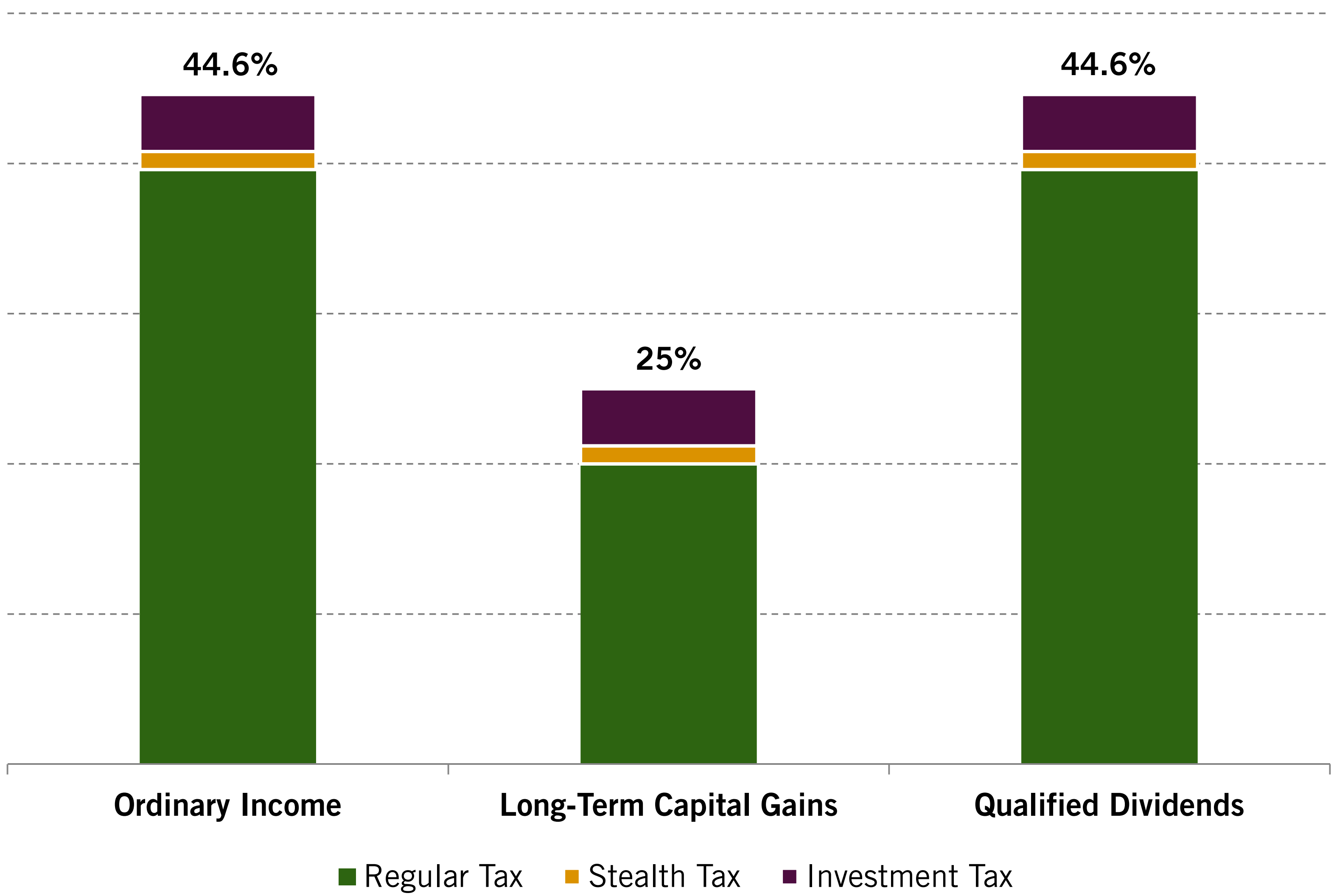
# Qualified Dividends



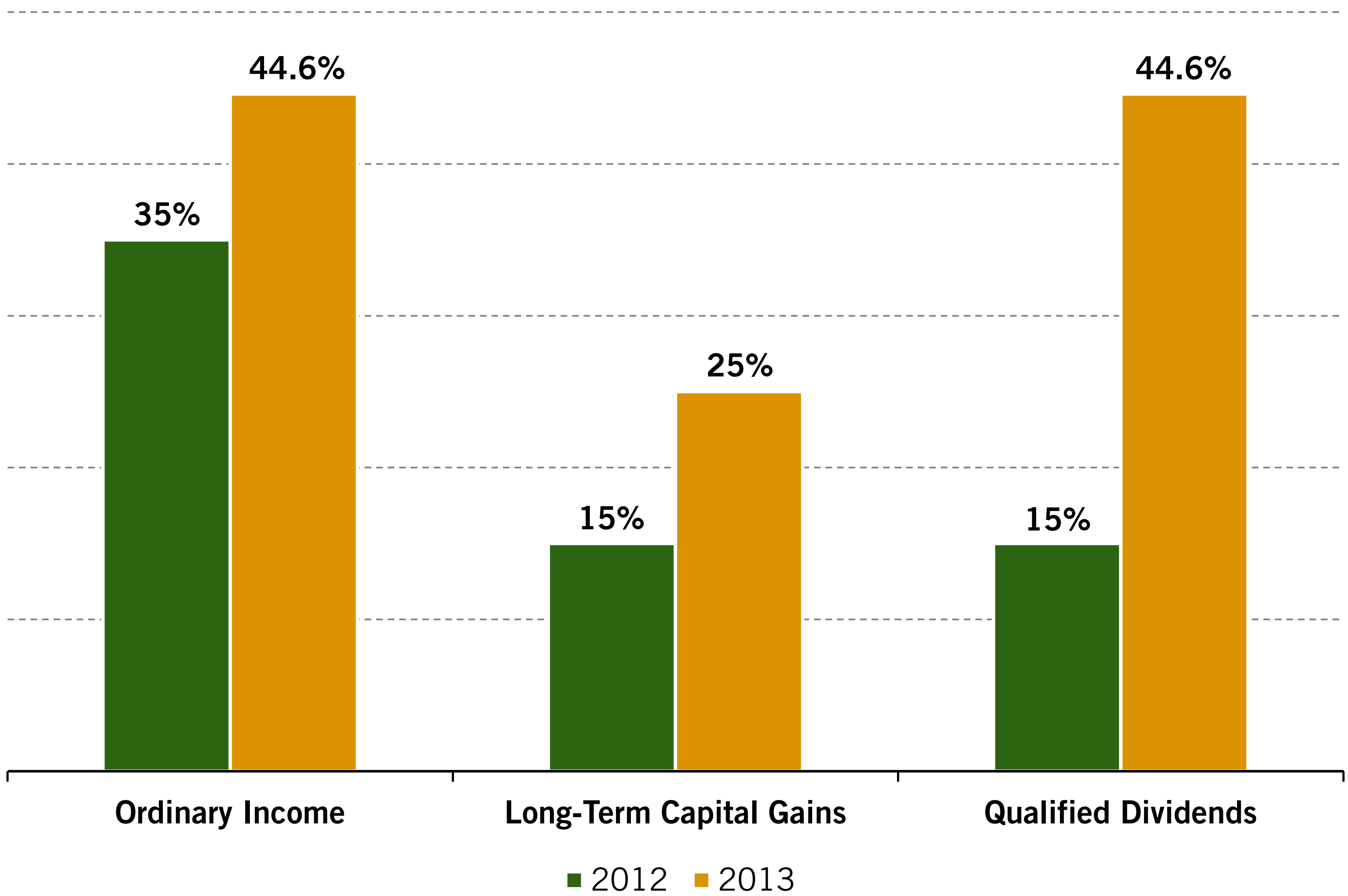
# Stealth Tax 2013
## Pease Provision – Reduction in Allowable Itemized Deductions



# Net Investment Income Tax



# Scheduled Tax Rate Changes



# Comparing Tax Platforms

### Mitt Romney

- Repeal federal estate tax
- Permanent extension of Bush Tax Cuts
- Repeal AMT
- Repeal Obamacare, including Investment Income Tax
- Reduce all tax rates by 20%
- Cut some deductions

### Barack Obama

- Estate and gift tax at 2009 rates
- No extension of Bush Tax Cuts for higher income taxpayers
- Buffett Rule minimum tax
- 20% Tax Rate on Long-Term Capital Gains and Qualified Dividends
- Pease Provision "Stealth Tax" back in force
- Limit value of itemized deductions and certain exclusions to 28% for higher income taxpayers
- Carried Interest taxed as ordinary income

# How to Prepare?

- Understand current tax posture
- Review balance sheet
- Focus on deferred tax liability
- Be ready to act by year-end

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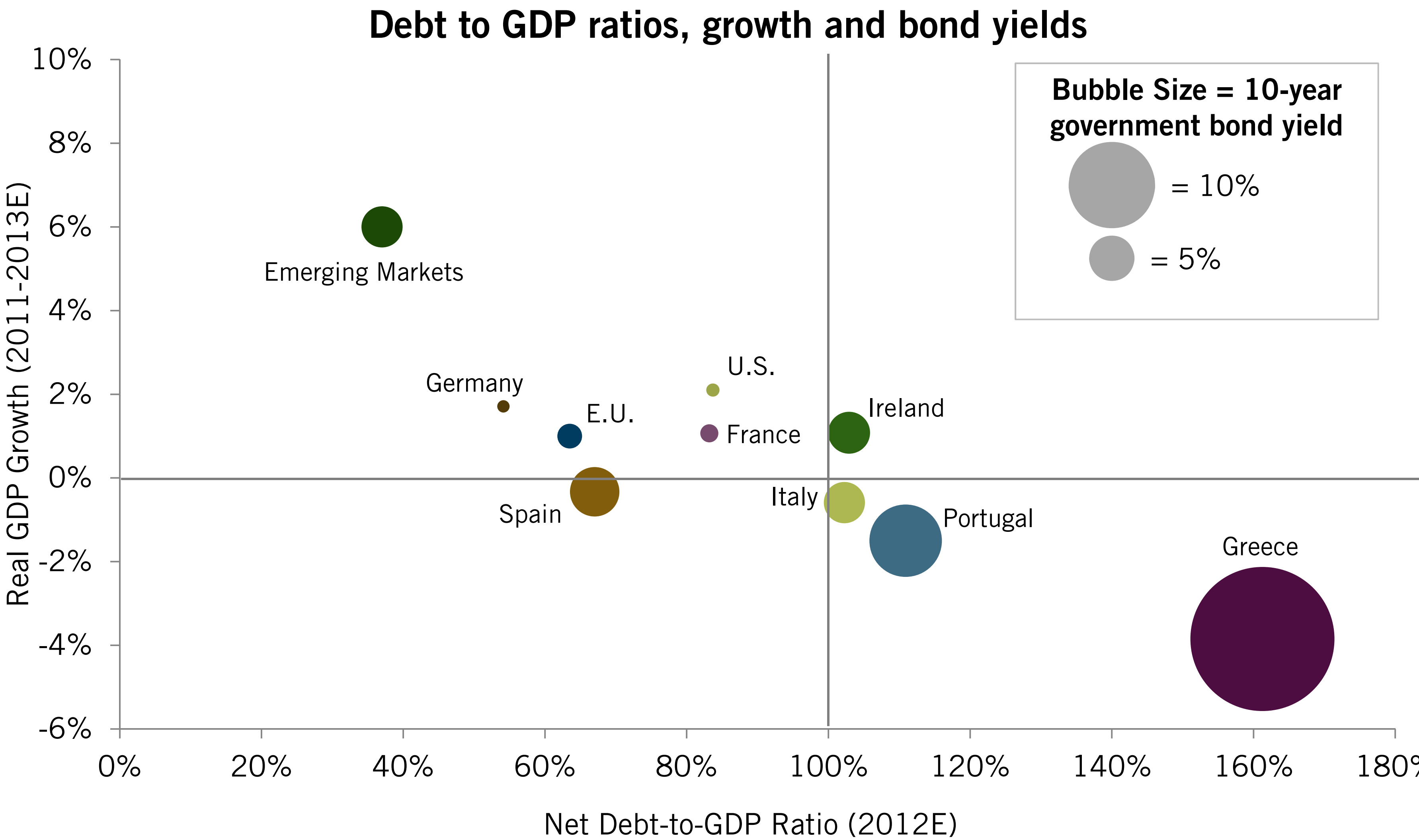
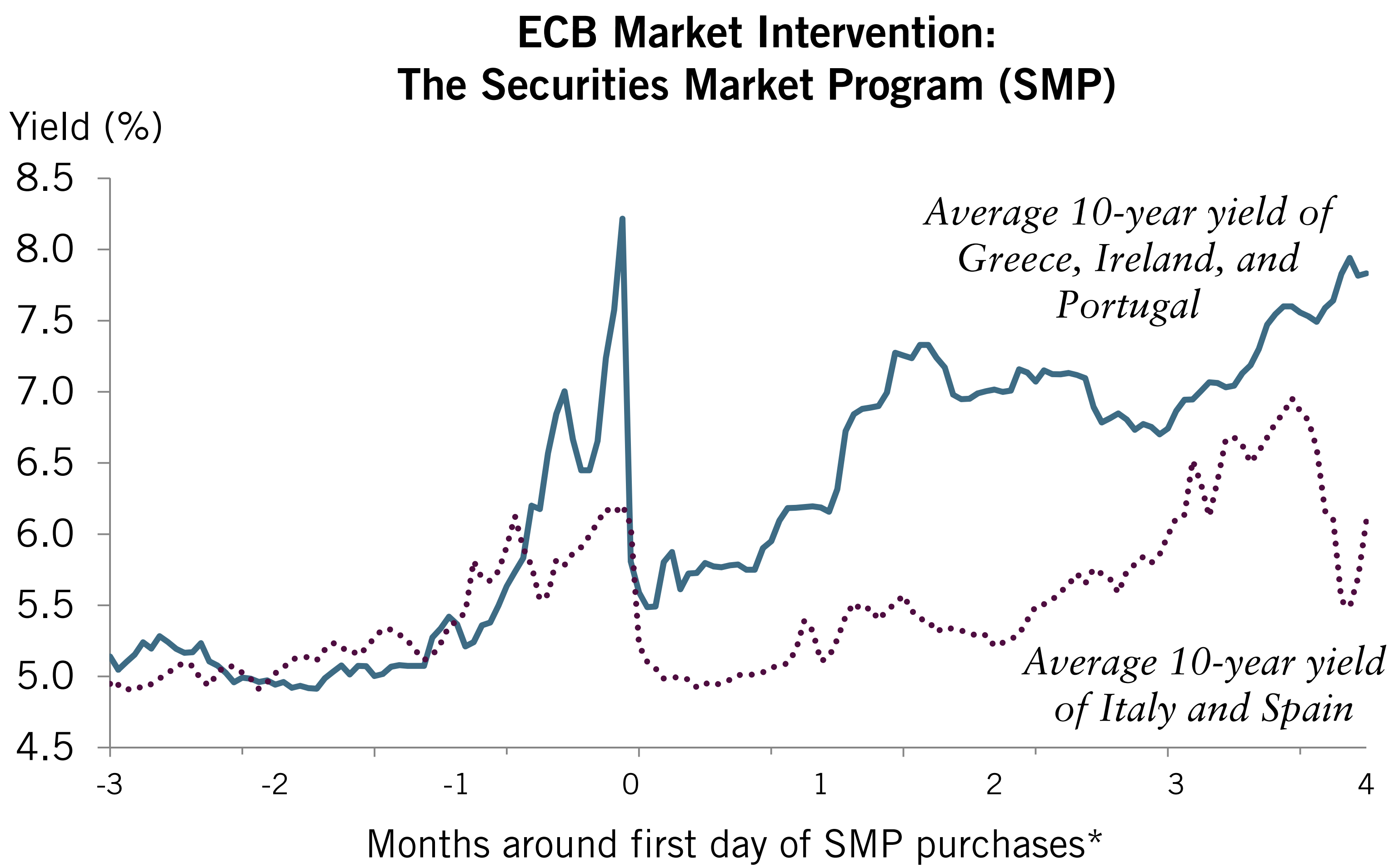
# Europe: Trying to Avoid the "Austerity Trap"




As of September 30, 2012.

Source: Bureau of Economic Analysis, FactSet, International Monetary Fund

# Europe: OMT Needs To Be More Effective than SMP




ECB market intervention/SMP as of August 10, 2012.

*The SMP purchase program was started on May 10, 2010 for Greece, Ireland, and Portugal. The program was re-initiated on August 4, 2011 for Ireland and Portugal and first started buying Italy and Spain on August 8, 2011.

Source: FactSet, J.P.Morgan

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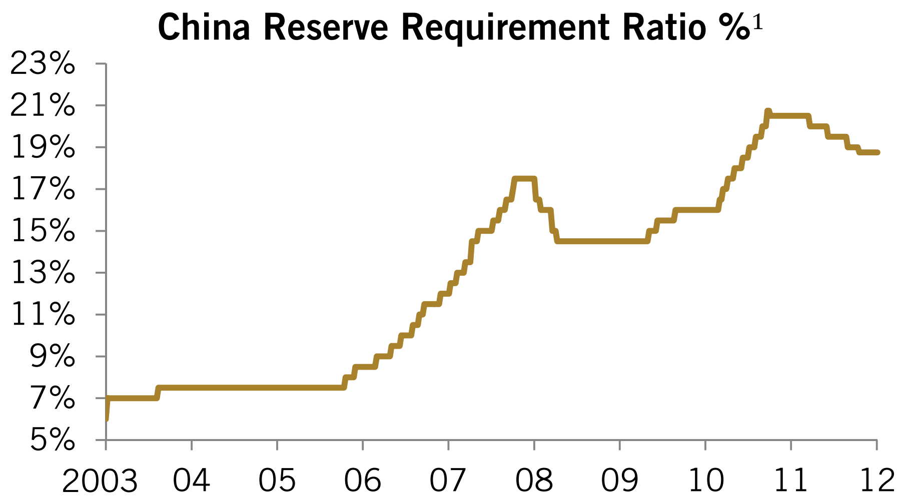
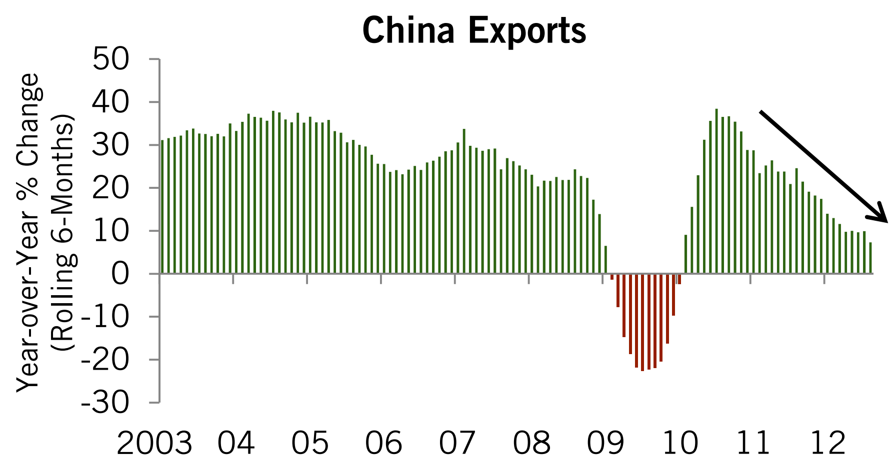
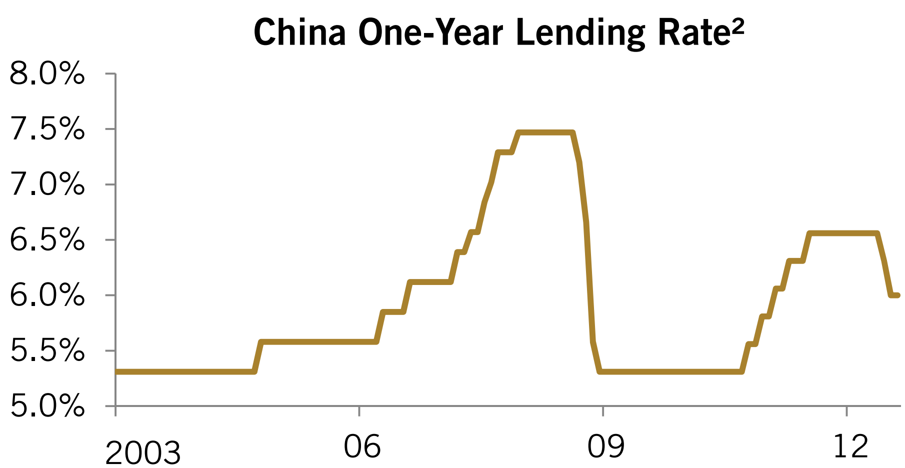
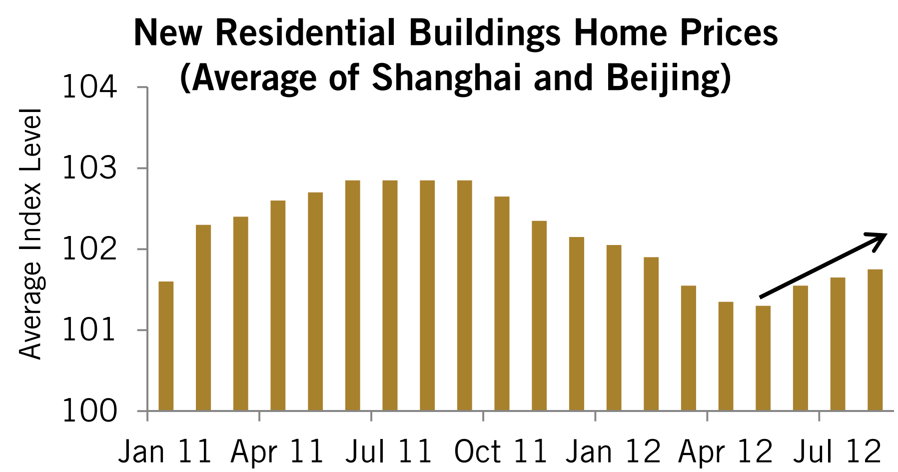
# China: Interest Rates and Housing




[1]Since November 2011, the Chinese government has lowered the RRR four times from 20.5% to current 18.8% which took place in early July. [2]Since June 2012, there have already been two rate drops, one announced in early June which dropped rates to 6.3% and another in early July dropping rates to 6.0%.

Source: China Customs, FactSet, International Monetary Fund, National Bureau of Statistics of China, People's Republic Bank of China

# China: Coming Months Set Stage for Coming Decade

## Chinese Political Structure


- November through March will see hundreds of Chinese political leadership positions change hands
- Little is known about upcoming leadership beyond top two "nominees"
- Longer-term Chinese economic outlook a big question mark, not just for local assets but for global portfolios

Source: ISI

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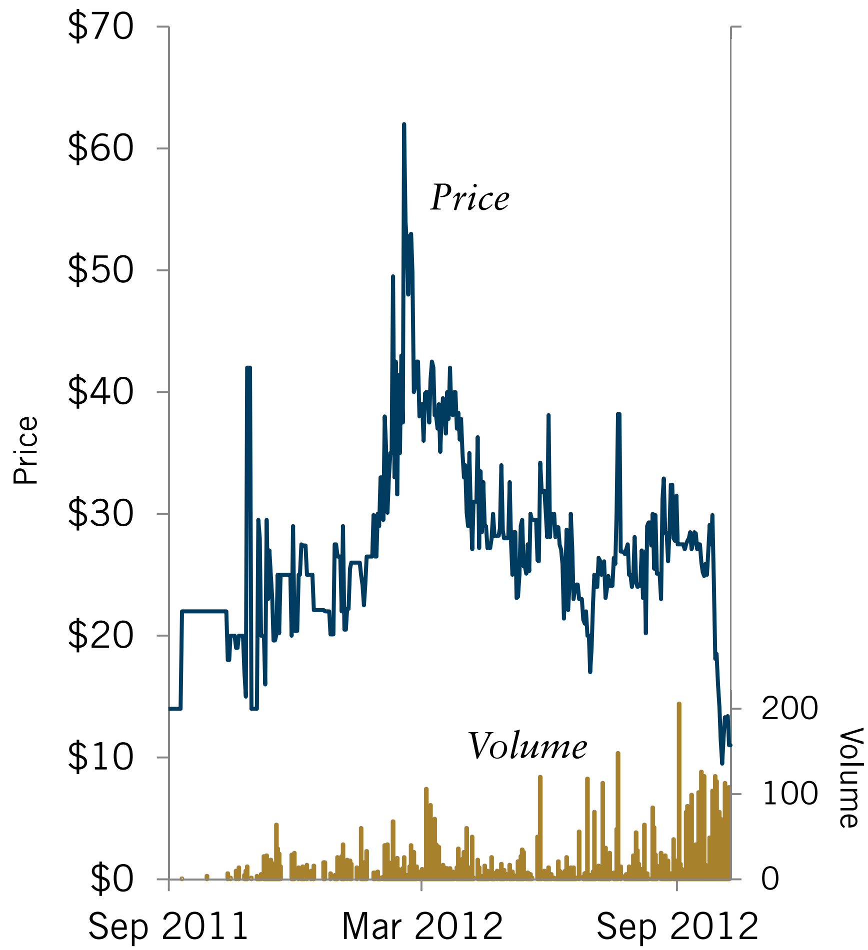
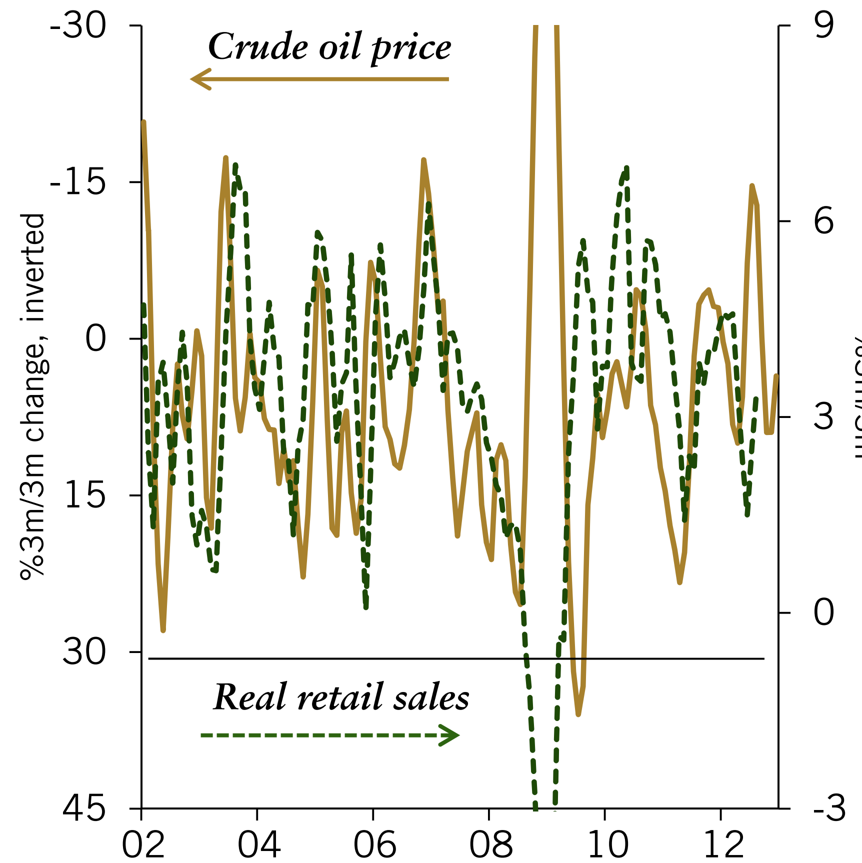
# Middle East: Supply shock = stagflation worries

### Odds of 2012 conflict have fallen




### Oil price and retail sales volumes, global




Intrade data as of October 9, 2012. Global retail sales and crude oil price reflects seasonally adjusted annual rate estimated through December 31, 2012.
Source: Bloomberg, Intrade, J.P.Morgan

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# Economic Growth Is Not A Good Predictor of Stock Market Performance

### Years When U.S. GDP Growth Was Below 2%

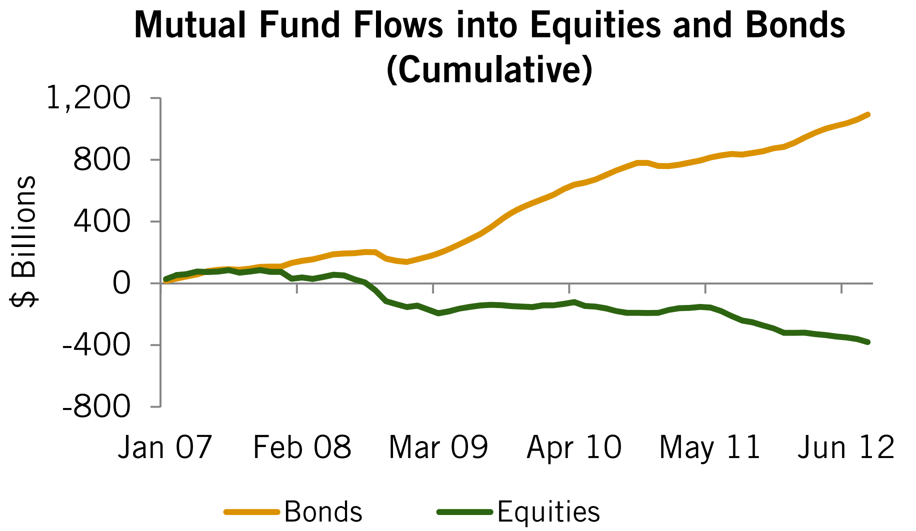
| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | | 1991 |
| | | | | | | | 1980 |
| | | | | | | | 1945 |
| | | | 1990 | | | | 1938 |
| | | | 1981 | 2011 | | | 1933 |
| | 2002 | | 1953 | 1970 | | | 1928 |
| | 1974 | | 1946 | 1960 | | 2009 | 1927 |
| | 1930 | 2001 | 1932 | 1956 | 1979 | 1982 | 1915 |
| 2008 | 1917 | 1957 | 1914 | 1947 | 1949 | 1924 | 1908 |
| 1931 | 1907 | 1920 | 1913 | 1902 | 1921 | 1919 | 1904 |
| <(30)% | (20)-(30)% | (10)-(20)% | (0)-(10)% | 0-10% | 10-20% | 20-30% | >30% |

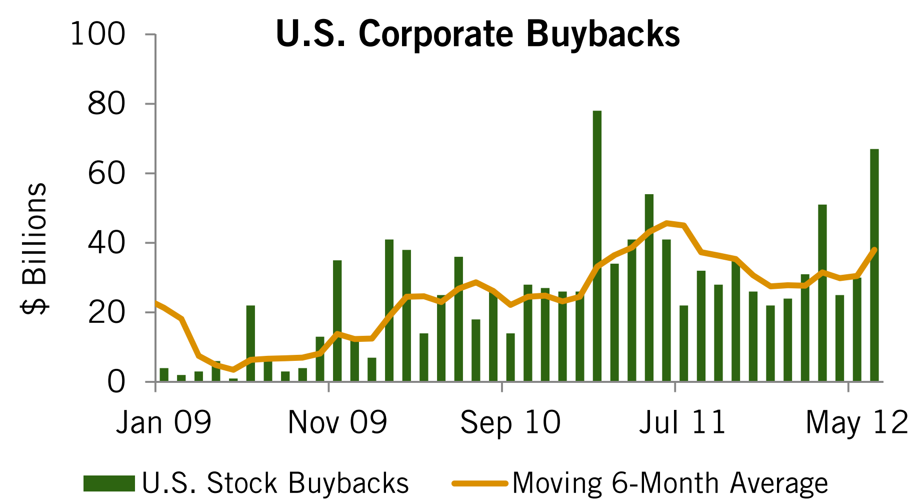
**S&P 500 Returns**

As of December 31, 2011.

Source: Bureau of Economic Analysis, Standard & Poor's

# With So Many Headwinds, Why Are Equities Rising?

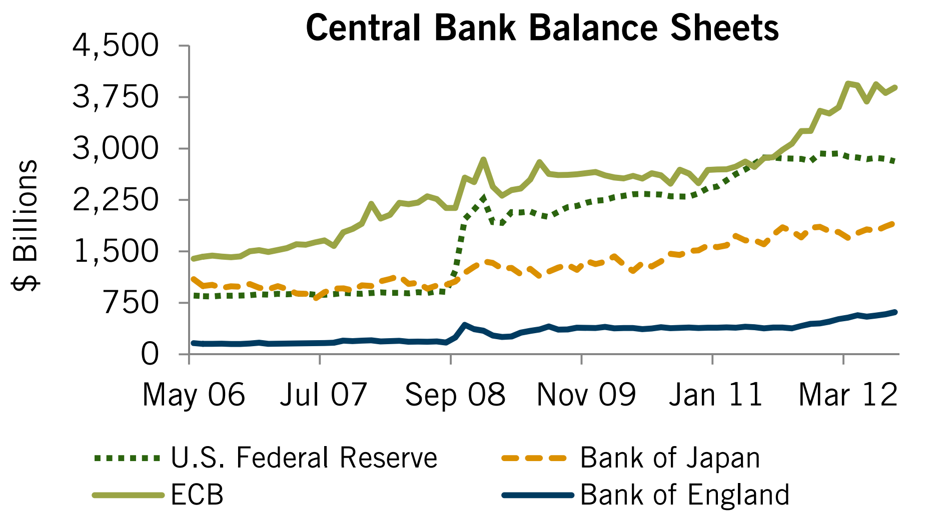


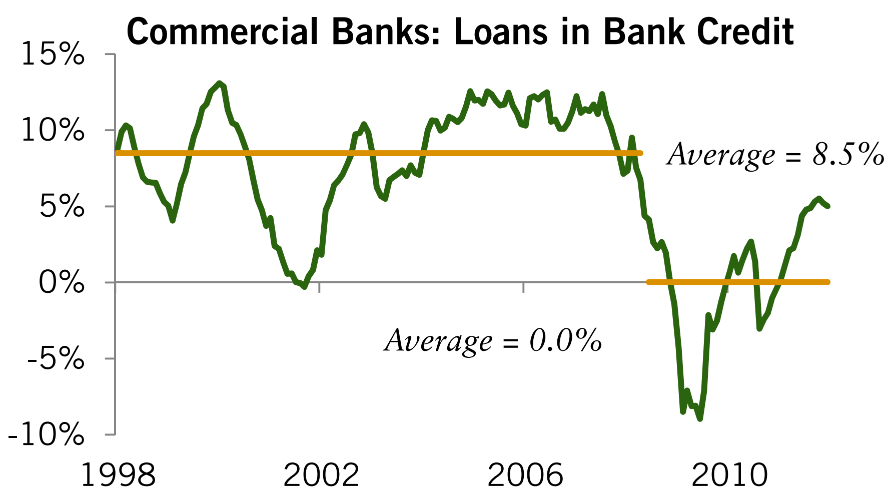




- **Mutual fund investors continue to sell equities, but …**
  - Some sales are simply migrating to ETFs
  - U.S. corporate buybacks are rising
  - Hedge funds – in recent months – have been adding back to cyclical assets, including equities
  - Sovereign Wealth Funds (SWFs) are not "adding" to equities, but remain notable buyers as they put reserves to work
- **We believe corporate and SWF support for U.S. equities can continue into 2013, while hedge fund support is more of a question mark**

Mutual fund flows as of August 31, 2012. Corporate buybacks as of June 30, 2012.
Source: Investment Company Institute, Standard & Poor's

# Rising Bond Yields May Be Needed to Move More Mutual Funds Out of Bonds and Into Stocks




- **Continued, extraordinary central bank stimulus is raising concerns over future inflation**
- **Plenty to worry about – Bernanke not even likely to be at Fed when it is time to unwind QE**
- **Inflation does not seem a 2013 issue, however:**
  - Wages
  - Housing
  - Lending
- **We see investment opportunities in inflation-sensitive assets now, even if broader inflation remains muted**

As of July 31, 2012.
Source: Federal Reserve

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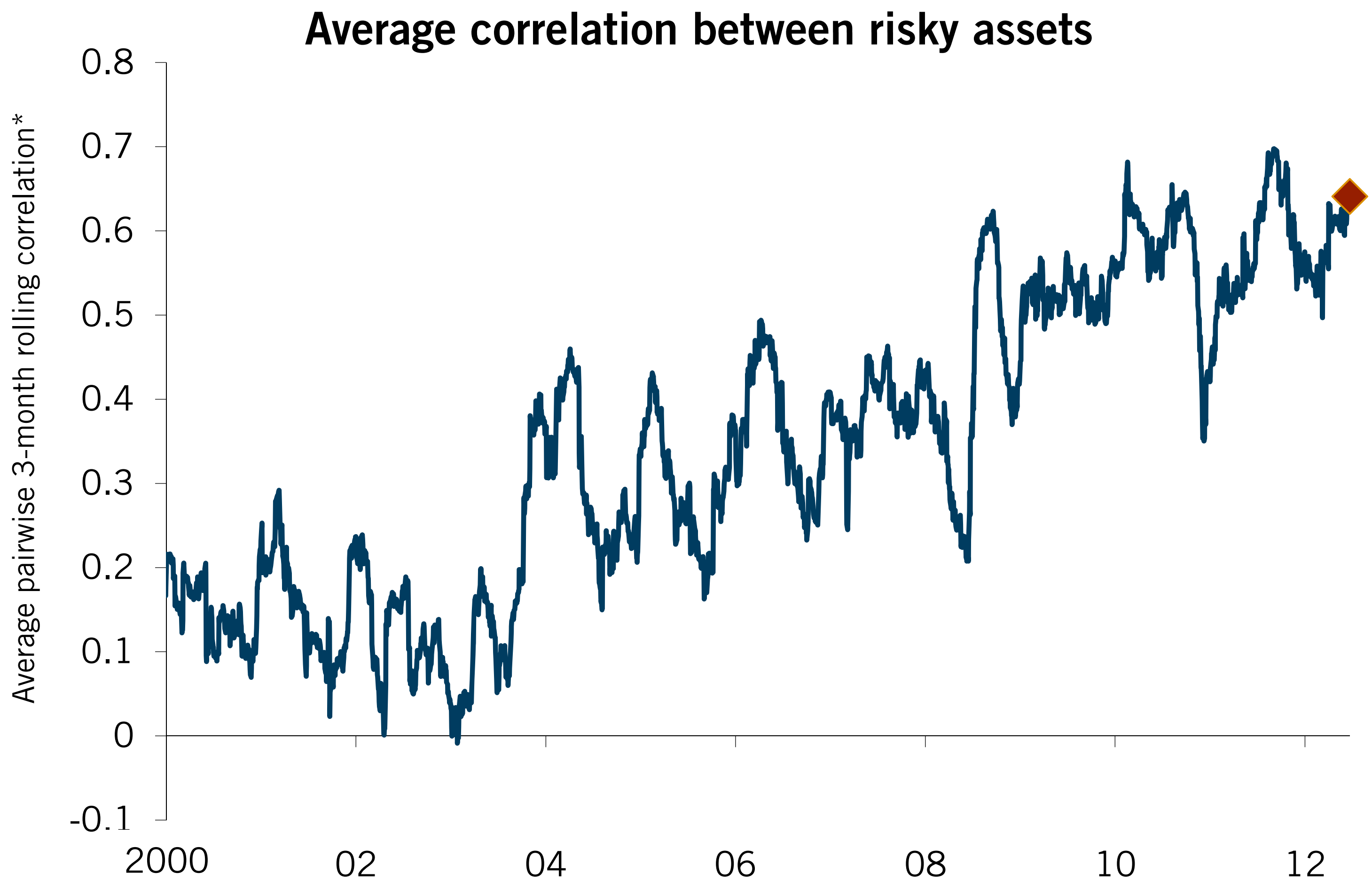
# Hedge Funds Facing Challenge from Rising Correlations

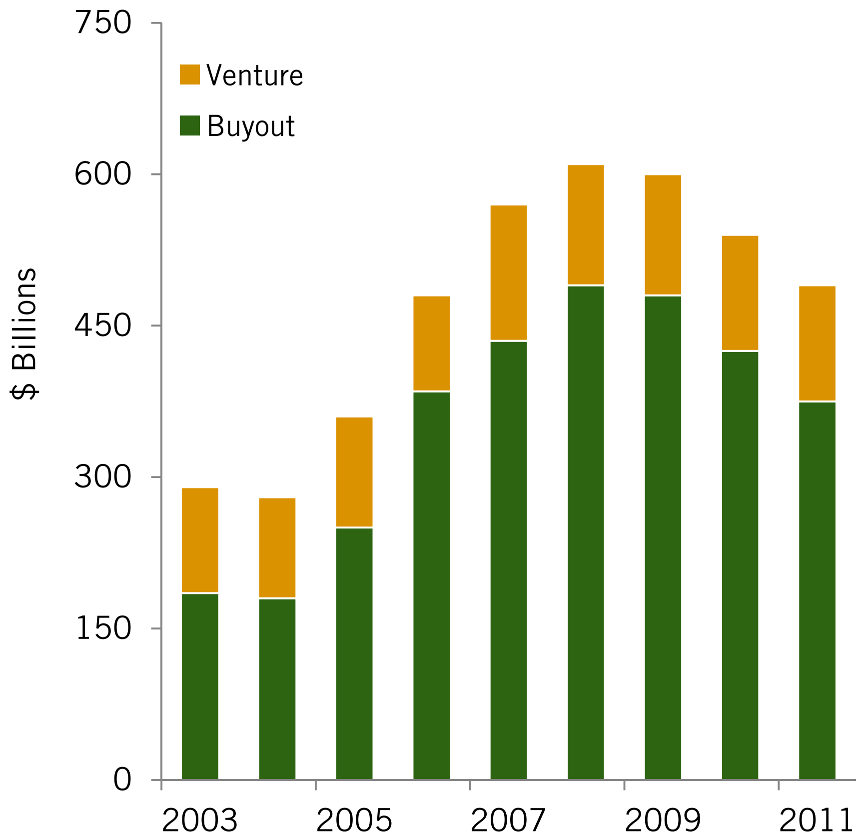



Average pairwise 3-month rolling correlation of daily returns between S&P 500 Index, U.S. Dollar Index (inverse), S&P Goldman Sachs Commodity Index, emerging markets, foreign exchange, MSCI emerging markets, and U.S. high-yield credit.

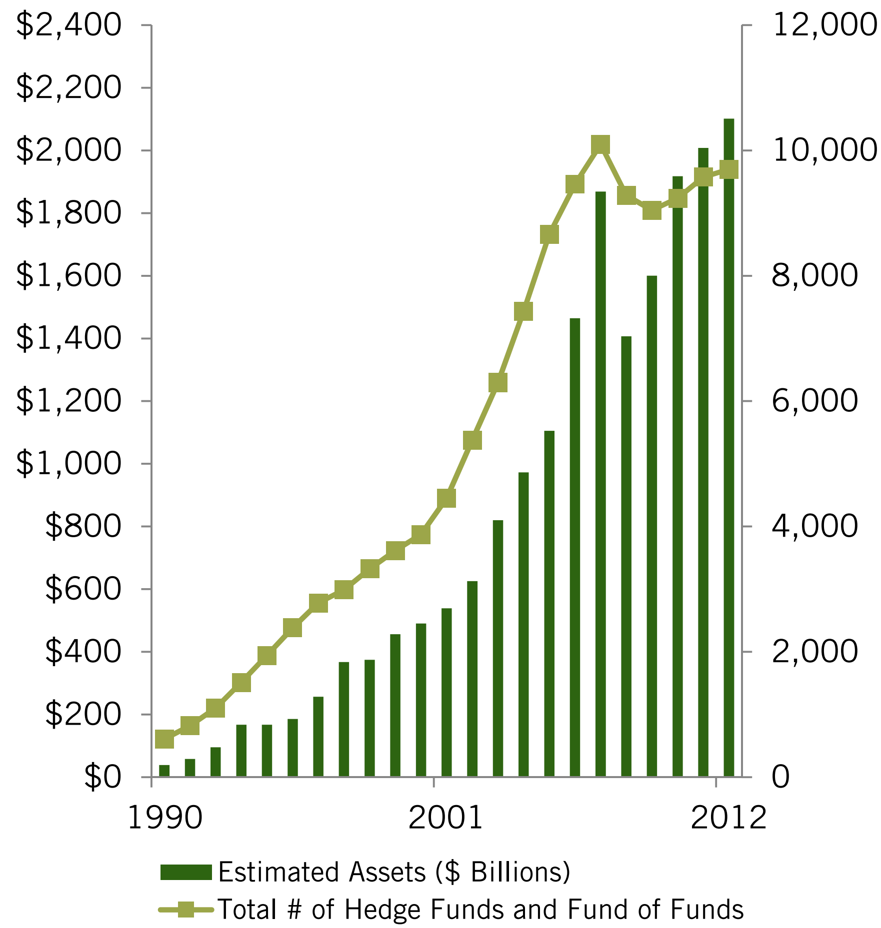
Source: Bloomberg, J.P.Morgan

# Just Too Much: Private Equity and Hedge Funds

### The "Capital Overhang" in Private Equity




### Hedge Fund Competition Rising

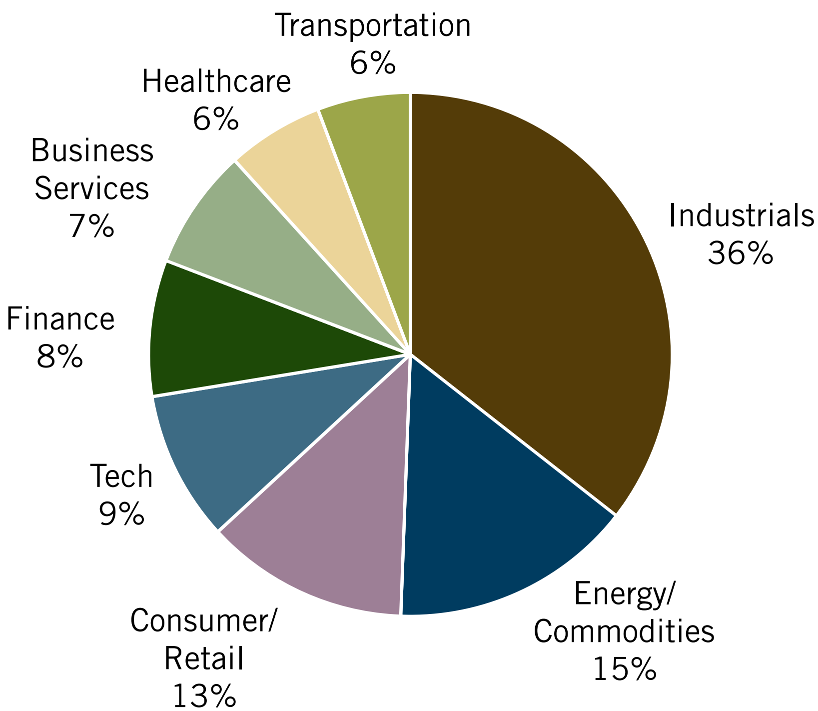



Data for private equity as of December 31, 2011; hedge funds as of June 30, 2012.

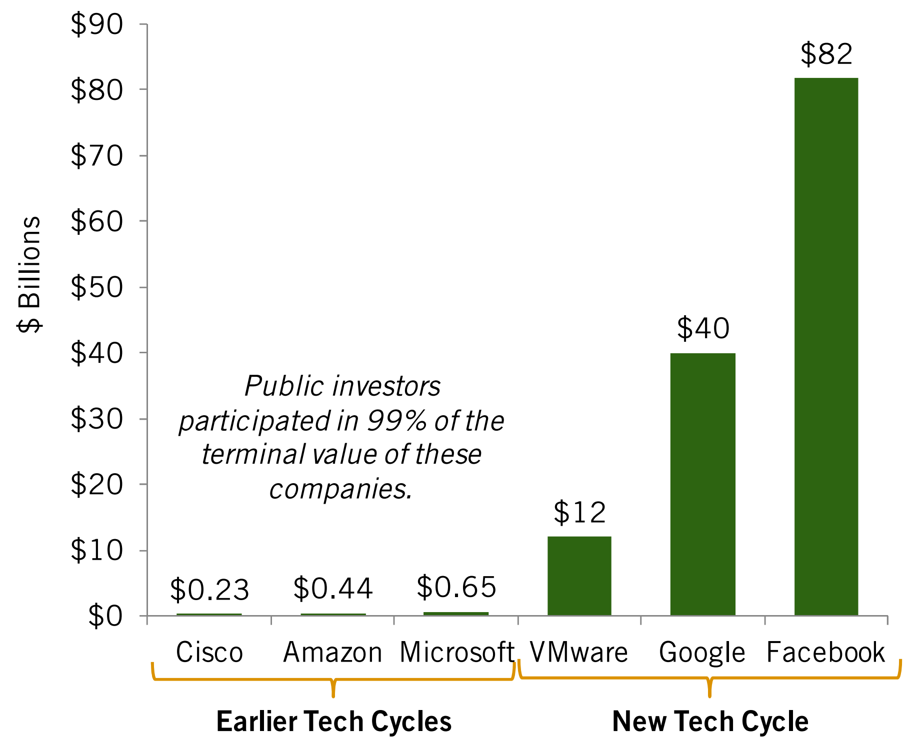
Source: Hedge Fund Research, Prequin

# Hedge Funds and Private Equity: Still Best Option for Certain Investment Themes

**Private Equity: Chinese Public Companies by Sector**[1]




**Technology: Pre-Money IPO Valuations**[2]




[1]Sector data based on Shanghai Stock Exchange Composite Index as of July 23, 2012. Figures indicate number of companies as percentage of the Index.
[2]Quigley Report, May 2, 2011. Updated for Facebook IPO on May 18, 2012.
Source: FactSet

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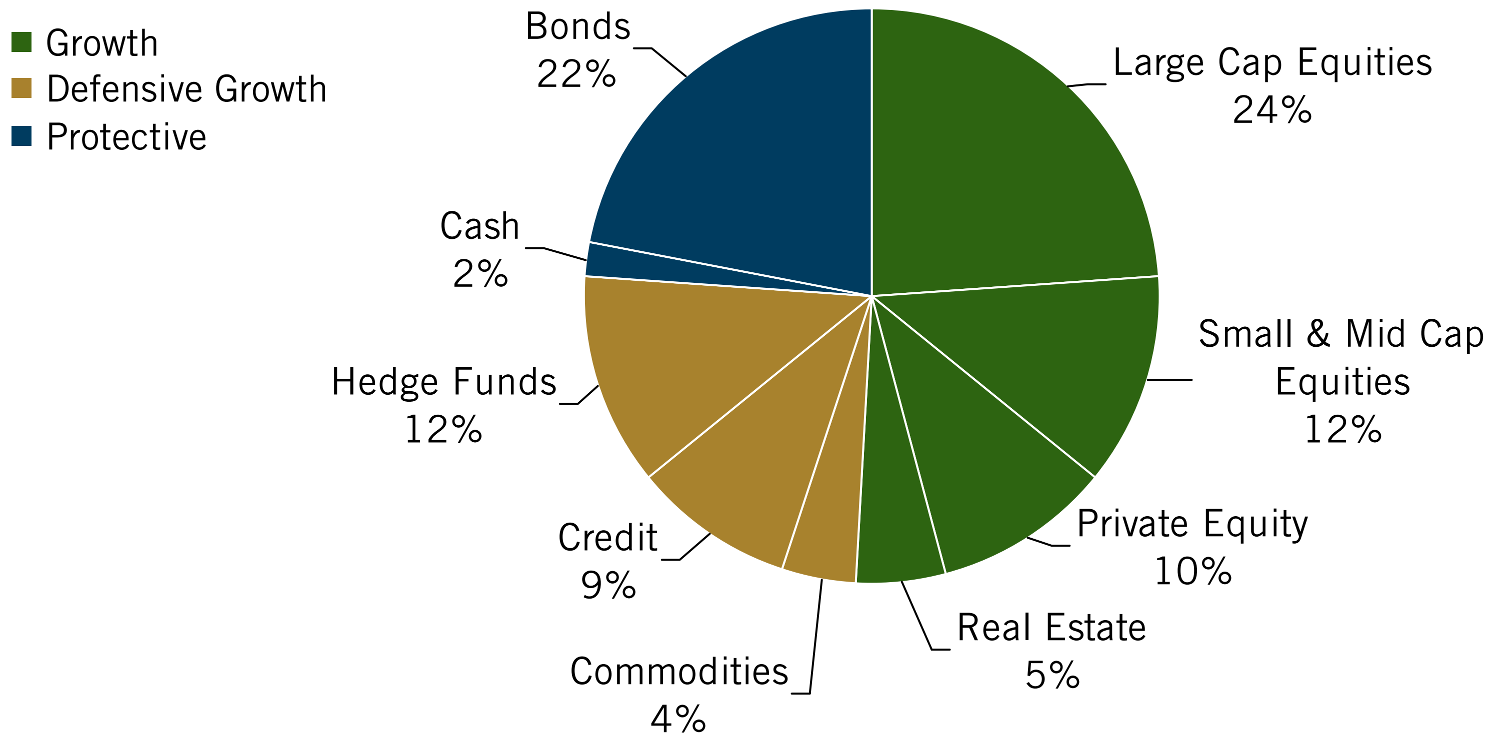
# The Bottom Line

| Our View | Portfolio Actions |
| --- | --- |
| Central Bank actions keep bond yields low and put a floor under cyclical asset valuations | • Underweight high quality bonds<br>• Maintain reasonable exposure to equities globally<br>• Maintain some inflation hedges |
| Potential policy missteps (including in the U.S. and Europe) cap upside for risk assets | • Overweight investments that offer yield and strong fundamentals (e.g. MBS, convertible bonds, emerging market debt) |
| Political transition adds to uncertainty for China's economy | • Take selective approach to China and related investments – including emerging markets and commodities |

# Combining Growth and Protection




**Potential for choppy markets leads us to maintain our slightly defensive posture, while capturing growth opportunities**

As of September 30, 2012.

This model displays Bessemer's suggested model portfolio allocation guidelines. Each client situation is unique and maybe subject to special circumstances, including but not limited to greater or less risk tolerance, classes and concentrations of assets not managed by Bessemer, investment limitations imposed under applicable governing documents, and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the foregoing or other factors.

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